STAFF PAPER

July 2018

IASB Meeting

Project	**Costs considered in assessing whether a contract is onerous (IAS 37)**
Paper topic	Possible narrow-scope standard-setting

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Introduction and purpose

1. At its November 2017 meeting, the IFRS Interpretations Committee (Committee) decided to add a project to its standard-setting agenda to clarify the meaning of the term 'unavoidable costs' in the IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* definition of an onerous contract.

2. The Committee discussed this matter at its meetings in March and June 2018. The Committee decided to recommend that the International Accounting Standards Board (Board) propose:

   (a) narrow-scope amendments to IAS 37 to:

      (i) specify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract'; and

      (ii) provide examples of costs that do, and do not, relate directly to a contract to provide goods or services.

   (b) no new requirements for entities to disclose additional information about onerous contracts.

   (c) specific transition requirements for entities already reporting using IFRS Standards. Such entities would be required to apply a 'modified retrospective' approach whereby they would apply the proposed amendments to contracts existing at the date of initial application (the beginning of the annual reporting period in which the entity first applies the amendments).

(d) no specific transition requirements for entities adopting IFRS Standards for the first time.

3. The Board has a wider project on IAS 37 in its research pipeline. The purpose of that research project will be to decide whether to add to the Board's standard-setting agenda a project to amend aspects of IAS 37 and, if so, what the scope of that project should be. The matter being addressed by the Committee is one that the Board has previously identified for consideration within its research project.

4. The purpose of this paper is to ask the Board whether it agrees with the Committee's recommendations.

Background information

5. The Committee received a request to clarify the costs an entity considers when assessing whether a contract is onerous applying IAS 37. In particular, the request asked about the application of IAS 37 to contracts with customers that were previously within the scope of IAS 11 *Construction Contracts*. For financial periods beginning on or after 1 January 2018, such contracts are within the scope of IFRS 15 *Revenue from Contracts with Customers*.

6. IAS 11 contained specific requirements on the costs an entity would and would not include in identifying, recognising and measuring an onerous contract liability for contracts that were within its scope.

7. In contrast, IFRS 15 does not include requirements for identifying and measuring onerous contract liabilities. Instead, as noted in paragraphs 5(g) of IAS 37 and BC296 of IFRS 15, an entity applies paragraphs 66–69 of IAS 37 in assessing whether a contract to which it applies IFRS 15 is onerous. Accordingly, the Committee concluded that, when determining which costs to include in assessing whether such a contract is onerous, the entity does not apply the previous requirements in IAS 11 on contract costs, and nor does it apply the requirements in IFRS 15 on costs that relate directly to a contract. Instead, the entity applies the definition of an onerous contract in IAS 37.

8. IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to

be received under it. Paragraph 68 of IAS 37 states that the unavoidable costs under a contract are the lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it. However, IAS 37 includes no further requirements on which costs to include in measuring the costs of fulfilling a contract.

9. The Board has a project on IAS 37 in its research pipeline. The Board has identified a variety of possible problems with IAS 37, including diverse interpretations of the term ‘unavoidable costs’ for identifying onerous contracts (see Agenda paper 14B for the July 2015 Board meeting). Projects in the research pipeline are not currently active. However, in February 2018 the Board decided that the staff should aim to complete the remaining research on IAS 37 reasonably soon after the Board issued the *Conceptual Framework for Financial Reporting*. Consequently, the Board has identified the IAS 37 research project as one of five projects in the research pipeline that it will aim to start in the next few months. The Board has not yet decided the extent and nature of any standard-setting that it may undertake.

Committee decisions—scope of possible standard-setting activities

10. In November 2017 the Committee discussed the scope of possible narrow-scope standard-setting activities to address the questions raised in the request.[1] It decided that:

    (a) any new requirements should apply to all onerous contracts within the scope of IAS 37, not only contracts within the scope of IFRS 15;

    (b) the scope of the project should be restricted to clarifying the requirements for identifying onerous contracts. The scope should not include adding requirements for measuring onerous contracts; and

    (c) the scope of the project should be to clarify only the term ‘unavoidable costs’ in the IAS 37 definition of an onerous contract—the scope should not include clarifying other aspects of the definition, such as the meaning of the phrase ‘economic benefits expected to be received’.

[1] See Agenda Paper 5 to that meeting.

11. At its December 2017 meeting the Board discussed the Committee's decisions about scope and had no specific comments, questions or suggestions for the Committee to consider.

Committee decisions—clarifying 'cost of fulfilling'

Which costs to include

12. Questions about the meaning of the term 'unavoidable costs' arise because IAS 37 does not specify which types of costs in entity includes in the 'cost of fulfilling' a contract.

13. IAS 37 applies to all onerous contracts except those for which there are onerous contract requirements in other IFRS Standards (eg IFRS 17 *Insurance Contracts*). Therefore, any requirements specifying the types of costs that make up the cost of fulfilling a contract would need to be operational for a variety of different contracts, including both sales contracts (for which the entity's obligation is typically to deliver goods or services) and purchase contracts (for which the entity's obligation is typically to pay cash).

14. However, questions about which costs make up the 'cost of fulfilling' a contract tend to arise mainly for contracts in which the entity's obligations are fulfilled by delivering non-monetary assets (such as goods or services). So, the Committee focused on such contracts.

15. In March 2018 the Committee considered two different approaches to identifying the costs that make up the cost of fulfilling a contact:

    (a) Approach A—include only the costs that the entity would avoid if it did not have the contract, ie the incremental costs of the contract; and

    (b) Approach B—include all the costs that the entity cannot avoid because it has the contract. Such costs would include both the incremental costs of the contract and an allocation of overhead costs incurred for activities required to fulfil the contract. Several Committee members noted that they expect there to be a strong relationship between the costs that relate directly to the contract and the activities required to fulfil the contract. Those Committee members suggested making that clear in the proposed amendments. Accordingly, in Approach B the overhead costs included would be restricted to those that 'relate directly to the contract'. This phrase is the same as the phrase used in IFRS 15.

Arguments for and against each approach

Approach A

16. Applying Approach A, the 'cost of fulfilling' a contract would include only the incremental costs of that contract.

17. In support of this approach, some stakeholders have argued that:

    (a) any other costs—that is, costs of resources that are shared across several contracts, or other overhead costs—will be incurred by the entity regardless of whether it fulfils that particular contract. So those other costs are not costs of 'fulfilling the contract'. They are instead costs that need to be incurred to operate in the future.

    (b) including overhead costs in an onerous contract provision would be inconsistent with the general requirements of IAS 37:

        (i) paragraph 18 of IAS 37 specifies that no provision should be recognised for costs that need to be incurred to operate in the future; and

        (ii) even if the overhead costs are expected to give rise to operating losses, the expectation of losses would not be enough to justify recognising a provision for those costs. Paragraph 63 of IAS 37 prohibits recognition of provisions for future operating losses. Paragraph 64 explains that this is because future operating losses do not meet the definition of a liability.

18. A possible criticism of an incremental costs approach is that it would fail to identify an onerous contract liability if an entity has several contracts that are expected to be profitable individually at an incremental cost level but are onerous as a group once shared costs are taken into account:

Example 1

	Individual contract	**Group of 10 contracts**
	CU million	CU million
Expected economic benefits	10	100
Incremental costs	(8)	(80)
Shared directly related costs	-	(50)
Profit/ (loss)	2	(30)

19. In this example, the entity expects to make losses of CU30 million on existing contracts but would not identify an onerous contract liability if it applied an incremental cost approach to assess individual contracts.

20. Such an outcome could be avoided by specifying that, if some of the resources required to fulfil contracts are shared across a group of similar contracts, an entity should identify onerous contract liabilities by considering the group of contracts as a whole. There is a precedent for such an approach within IAS 37. IAS 37 requires entities to recognise provisions if, among other things, it is probable that an outflow of resources will be required to settle the obligation. Paragraph 24 of IAS 37 states that 'where there are a number of similar obligations (eg product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligation as a whole'.

21. A possible criticism of a requirement to assess groups of similar contracts as a whole is that doing so could mask liabilities for contracts that are individually onerous. For example, suppose an entity has a group of ten similar contracts, but the expected incremental costs of fulfilling one of the contracts have increased to more than the expected economic benefits:

Example 2

	Nine contracts	**One contract**	**Group of 10 contracts**
	CU million	CU million	CU million
Expected economic benefits	90	10	100
Incremental costs	(72)	(12)	(84)
Shared directly related costs	-	-	(10)
Profit/ (loss)	18	(2)	6

22. If the contracts were assessed as a group, no onerous contract liability would be identified, despite one contract being onerous even at an incremental cost level.

23. Such an outcome could be avoided by modifying the incremental cost approach. The modified approach could require contracts to be assessed individually but to include the costs of shared resources if the costs of those resources will not be covered by other profitable contracts. It is likely that further application guidance would be required to implement such an approach.

Approach B

24. Applying Approach B, the costs of fulfilling a contract would include both the incremental costs of the contract and an allocation of other costs that relate directly to the contract.

25. To justify including an allocation of other costs that relate directly to the contract, the Board would need to address the argument that including overhead costs would be inconsistent with the general requirements of IAS 37—ie that it would amount to recognising a liability for 'costs that need to be incurred to operate in the future' or 'future' losses (see paragraph 17(b) of this paper). The Board could counter this argument by explaining that:

    (a) the entity would not be recognising a provision *for* the overhead costs. It would not be identifying these costs as present obligations in their own right. Instead the entity would be identifying its present obligation to deliver goods or services in exchange for other economic benefits, and measuring that obligation taking into account the full cost of the goods or services that it is obliged to deliver.

    (b) paragraph 63 prevents entities from recognising future operating losses on the grounds that such losses are not a liability, in other words that the entity does not have a present obligation to incur those losses. In contrast, in applying the onerous contract requirements the entity is determining the cost of fulfilling its present obligation in an existing contract to identify if that contract is onerous.

26. In support of an approach that includes both incremental costs and an allocation of other costs that relate directly to the contract, it can be argued that:

(a) such an approach provides the most faithful representation of the costs of fulfilling that contract. An entity can choose to obtain the resources it needs to fulfil a contract in different ways. For example, if an entity needs to use particular equipment to construct goods or deliver services, it could hire the equipment for the period required by the contract, or buy the equipment and use it for other contracts afterwards. Similarly, if it needs to prepare technical reports, it could engage a professional firm to prepare only the reports needed for an individual contract, or it could employ its own team of experts to prepare the reports for all its contracts. Either way, the entity incurs costs to obtain the use of the equipment or the information in the reports. Just because the entity chooses to buy its own equipment or employ its own experts doesn't mean that the use of the equipment or information necessary to fulfil a contract are cost-free.

(b) ideally, the way in which an entity identifies the cost of fulfilling a contract to deliver goods should be consistent with the way in which it identifies the cost of those goods when it holds them. Consistency ensures that resources needed to fulfil a contract are measured in the same way, regardless of whether the entity has yet obtained them. As detailed in the Appendix to this paper, IFRS Standards that specify the types of cost to include in the measurement of a non-monetary asset all require the entity to include both the incremental costs of purchasing or constructing the asset and an allocation of directly related or directly attributable costs.

(c) applying an approach that includes an allocation of shared contract costs would lessen the need to specify circumstances, if any, in which entities should assess groups of similar contracts together, rather than individually. In Example 1 following paragraph 18 of this paper, the entity would recognise the same onerous contract liability whether it assessed the ten contracts individually (loss after allocation of shared costs of CU3 million per contract) or as a group (total loss CU30 million). In Example 2, the entity would assess its contracts individually and identify a liability for its one onerous contract. These outcomes would be achieved without any need for the Board to specify modifications to the basic requirements.

(d) recognising in an onerous contract provision the costs that the entity cannot avoid because it has the contract is consistent with the requirement in paragraph 80 of IAS 37 to recognise in a restructuring provision the costs that are 'necessarily entailed' by the restructuring.

27. Thus, it can be argued that including in the 'cost of fulfilling' a contract both the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to the contract would:

(a) be consistent with other requirements in IAS 37;

(b) result in a more faithful representation of the cost of fulfilling a contract than would result from including only incremental costs; and

(c) enable the Board to specify requirements in IAS 37 that are broadly consistent with those of other Standards.

Committee's conclusions

28. The Committee concluded that in the context of paragraph 68 of IAS 37, the 'cost of fulfilling' a contract should include both the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to the contract.

Examples

29. IFRS 15, IFRS 17, IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property* all include examples of costs that are included in, and excluded from, the cost of an asset. The Committee recommended the inclusion of similar examples in IAS 37 to help clarify the types of cost that an entity would include in assessing the 'cost of fulfilling' a contract to provide goods or services.

30. The Committee concluded that the examples for IAS 37 could be based on the examples in IFRS 15, adapted to apply to contracts with counterparties other than customers. By way of illustration:

(a) the examples in IFRS 15 of costs that relate directly to a contract could be amended as follows (new text is underlined and deleted text is struck through):

> Costs that relate directly to a contract ~~(or a specific anticipated contract)~~ to provide goods or services include any of the following:
>
> (a) direct labour (for example, salaries and wages of employees who provide the promised goods or services directly to the counterparty ~~customer~~);
>
> (b) direct materials (for example, supplies used in fulfilling the contract ~~providing the promised services to a customer~~);
>
> (c) allocations of costs that relate directly to the contract or to contract activities (for example, costs of contract management and supervision, insurance and depreciation of tools, equipment and right-of-use assets used in fulfilling the contract);
>
> (d) costs that are explicitly chargeable to the counterparty ~~customer~~ under the contract; and
>
> (e) other costs that are incurred only because an entity entered into the contract ~~(for example, payments to subcontractors)~~.

(b) the examples in IFRS 15 of costs that do not relate directly to a contract could be amended as follows (new text is underlined and deleted text is struck through):

> ~~An entity shall recognise the~~ The following costs do not relate directly to a contract ~~as expenses when incurred~~:
>
> (a) general and administrative costs (unless those costs are explicitly chargeable to the counterparty ~~customer~~ under the contract, in which case an entity shall evaluate those costs in accordance with paragraph ~~97~~XX);

(b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

~~(c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and~~

~~(d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).~~

Committee decisions—disclosure requirements

31. At its meeting in June 2018 the Committee discussed whether the proposed amendments to IAS 37 should include requirements for entities to disclose additional information about onerous contracts.

32. Paragraphs 84 and 85 of IAS 37 contain disclosure requirements for provisions, including those arising from onerous contracts:

> 84 For each class of provision, an entity shall disclose:
>
> (a) the carrying amount at the beginning and end of the period;
>
> (b) additional provisions made in the period, including increases to existing provisions;
>
> (c) amounts used (ie incurred and charged against the provision) during the period;
>
> (d) unused amounts reversed during the period; and
>
> (e) the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
>
> Comparative information is not required.
>
> 85 An entity shall disclose the following for each class of provision:
>
> (a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

> (b) an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and
>
> (c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

33. The Committee decided that no new disclosure requirements should be proposed because:

    (a) the proposed amendments would be narrow in scope. They would not change the underlying principle or general requirements for onerous contracts; rather, they would clarify 'the cost of fulfilling' a contract when applying the onerous contract requirements in IAS 37. The proposed amendments would not therefore create additional judgements that would necessitate additional disclosure requirements.

    (b) onerous contracts previously within the scope of IAS 11 are now within the scope of IAS 37. IAS 11 did not contain disclosure requirements specifically for onerous contracts and, accordingly, applying the requirements in IAS 37 does not result in any loss of information for users of financial statements.

    (c) determining the cost of fulfilling a contract could, in some cases, require the use of estimates. However, this is not a new requirement that would result from the proposed amendment. Paragraph 85(b) of IAS 37 and paragraph 125[2] of IAS 1 *Presentation of Financial Statements* already require an entity to disclose particular information about uncertainties. It is beyond the scope of this narrow-scope project to consider more generally the adequacy of the existing disclosure requirements in IAS 37 for provisions.

[2] Paragraph 125 of IAS 1 states: 'An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of: (a) their nature, and (b) their carrying amount as at the end of the reporting period.'

Committee decisions—transition requirements

Entities already reporting using IFRS Standards

34. The proposed amendments to IAS 37 could result in some entities changing which costs they consider in assessing whether a contract is onerous. This could result in these entities including either fewer costs or additional costs in the assessment.

35. The Committee considered transition requirements for the proposed amendments to IAS 37, starting with whether an entity could transition to the proposed amendments applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* rather than by applying transition requirements developed specifically for the amendments.

36. An entity that, as a result of the amendments, would include additional costs may be required to obtain information about particular costs that it had not previously captured. IAS 8 would not require an entity to do this for prior periods if doing so would be impracticable. However, there could be some situations in which it might be difficult (and costly) to obtain the information needed at the start of the earliest prior period presented, but not impracticable to do so (as defined by IAS 8[3]).

37. Onerous contracts are often non-recurring in nature and, thus, retrospective application applying IAS 8 would not generally provide users of financial statements with useful trend information. Users may obtain some useful information if retrospective application were to highlight a particular point in the fulfilment of contracts that repeatedly causes an entity's contracts to become onerous—however, this is not expected to be common.

38. The Committee considered two other approaches for how an entity could transition to the proposed amendments:

    (a) prospective application as defined in IAS 8; and

    (b) modified retrospective application—ie an entity would apply the proposed amendments to contracts existing at the date of initial application.

[3] The definition of impracticable in IAS 8 states that 'applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so'.

Prospective application as defined in IAS 8

39. Paragraph 5 of IAS 8 defines prospective application of a change in accounting policy as ‘applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed’.

40. In practice, we think prospective application of these proposed amendments would require an entity to apply the amended requirements only to contracts entered into on or after the effective date. Entities would continue to apply the previous requirements to contracts existing at the effective date. This could result in an entity applying two different assessments for contracts entered into before and after the effective date of the amendments, which could last for some considerable time if the entity has long-term contracts.

Modified retrospective application

41. Applying a modified retrospective approach, an entity would apply the proposed amendments to contracts existing at the date of initial application (ie the start of the annual reporting period in which the entity first applies the amendments). Entities would not restate comparative information, and instead would recognise the cumulative effect of initially applying the amendments in retained earnings (or another component of equity, as appropriate) at the date of initial application.

42. This approach is similar to the transition approach permitted by some IFRS Standards, such as IFRS 9 *Financial Instruments*, IFRS 15, IFRS 16 *Leases* and IFRIC 23 *Uncertainty over Income Tax Treatments*.

43. The Committee concluded the modified retrospective approach avoids the drawbacks of retrospective application applying IAS 8 (see paragraphs 36–37 above) and prospective application (see paragraph 40 above). The Committee noted the modified retrospective approach would balance costs incurred by an entity in applying the proposed amendments with the usefulness of information provided to users of financial statements.

44. Accordingly, the Committee recommend proposing that entities would apply the modified retrospective approach when first applying the amendments.

45. The Committee also discussed whether the Board should provide an option to apply the amendments retrospectively (as discussed in paragraphs 35–38 of this paper). The

Committee concluded that the benefits of that approach would be limited and are outweighed by the disproportionate complexity and possible loss of comparability across entities that such an option would introduce. Accordingly, the Committee recommend not providing entities with this option.

Entities adopting IFRS Standards for the first time

46. The Committee also considered whether to propose specific transition relief for entities that are adopting IFRS Standards for the first time. The Committee recommend no specific transition requirements for first-time adopters because:

    (a) a first-time adopter would be able to apply the proposed amendments at its date of transition to IFRS Standards, and would not need specific relief to do so[4]; and

    (b) IFRS 1 does not provide any exception or exemption from the requirements of IAS 37 for onerous contracts. Accordingly, there is no particular benefit to providing first-time adopters with an exemption relating to one aspect of assessing whether a contract is onerous.

Committee decisions—form of standard-setting activity

47. The Committee considered whether the Board should propose to issue an Interpretation of IAS 37 or amendments to IAS 37. Amendments could be made as part of the annual improvements process or as a separate narrow-scope project.

48. The Committee noted that:

    (a) an interpretation specifies how to account for particular transactions applying existing requirements, without changing those requirements.

    (b) amendments made as part of the annual improvements process are limited to changes that either clarify the wording in a Standard or correct relatively

[4] Paragraph BC27 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* states 'The Board expects that most first-time adopters will begin planning on a timely basis for the transition to IFRSs. Accordingly, in balancing benefits and costs, the Board took as its benchmark an entity that plans the transition well in advance and can collect most information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs.'

minor unintended consequences, oversights or conflicts between existing requirements of Standards.

(c) all other narrow-scope standard-setting undertaken is in the form of a narrow-scope amendment to a Standard.

49. At its March 2018 meeting, the Committee decided to recommend amending IAS 37 instead of issuing an interpretation. This is because:

(a) the proposals would add new requirements to IAS 37 that would apply to all onerous contracts rather than clarify how existing requirements should apply to particular types of onerous contracts.

(b) these new requirements could amount to no more than a few sentences of additional text. In which case, they could easily be inserted into IAS 37, without disrupting the structure of the Standard. The requirements would be more apparent and accessible to readers of IAS 37 if included within the body of the Standard, instead of in a separate interpretation.

50. The Committee further concluded that the proposed changes would be too significant to be made as part of the annual improvements process. Diverse views on the meaning of the term ‘cost of fulfilling’ mean that any amendments would do more than clarify ‘wording’ or correct a minor unintended consequence, oversight or conflict. The new requirements could have a significant effect on the costs entities consider in assessing whether a contract is onerous.

Questions for the Board

Questions for the Board
Does the Board agree with the Committee's recommendation to propose: (a) narrow-scope amendments to IAS 37 to: (i) specify that the 'cost of fulfilling' a contract comprises the 'costs that relate directly to the contract'; and (ii) provide examples of costs that do, and do not, relate directly to a contract to provide goods or services. (b) no new requirements for entities to disclose additional information about onerous contracts. (c) specific transition requirements for entities already reporting using IFRS Standards. Such entities would be required to apply a 'modified retrospective' approach whereby they would apply the proposed amendments to contracts existing at the date of initial application (the beginning of the annual reporting period in which the entity first applies the amendments). (d) no specific transition requirements for entities adopting IFRS Standards for the first time.

Appendix—Requirements in other IFRS Standards

A1. Other IFRS Standards that specify the types of costs to include in the measurement of the cost of a non-monetary asset are:

(a) IFRS 15 (for costs to fulfil a contract that are not within the scope of another Standard);

(b) IAS 2;

(c) IAS 16;

(d) IAS 38; and

(e) IAS 40.

A2. All the Standards listed in paragraph A1 use some notion of ‘directly related’ or ‘directly attributable’ costs when specifying which costs to include in the measurement of the cost of the asset. However, there are differences in terminology used to describe the costs:

(a) IFRS 15 uses the phrase ‘costs that relate directly to a contract’ for identifying the costs to fulfil a contract that an entity recognises as an asset;

(b) IAS 2 uses the phrase ‘costs directly attributable to’ the cost of purchase of inventories but ‘costs directly related to units of production’ for costs of conversion; and

(c) IAS 16, IAS 38 and IAS 40 all use the term ‘directly attributable’ to describe the costs included in the cost of property, plant and equipment, intangible assets and investment property.

A3. The Standards all list similar examples of the types of costs that would meet the description of ‘directly related’ or ‘directly attributable’ costs. Examples include:

(a) direct labour and material costs;

(b) allocations of costs that relate directly to the contract or to contract activities;

(c) other costs incurred in bringing an asset to its current location and condition; and

(d) costs of testing whether the asset is functioning properly

A4. All the Standards specify that entities exclude ‘general overhead’ or ‘administrative’ costs, although with some exceptions. Exceptions are:

(a) general and administrative costs that are explicitly chargeable to customers (IFRS 15).

(b) administrative overheads that contribute to bringing inventories to their present condition and location (IAS 2).

(c) administrative and other general overhead expenditure that can be directly attributed to preparing an internally generated intangible asset for use (IAS 38).

A5. IAS 2 is the only Standard that requires entities to include ‘indirect’ costs. However, the only indirect costs that it requires an entity to include indirect ‘costs of production’ and the examples it gives are similar to costs that IFRS 15 describes as costs that relate directly to a contract. For example, the costs that IAS 2 describes as ‘indirect costs of production’ include depreciation and maintenance of factory buildings and the cost of factory management and administration. These are similar to the depreciation and contract management and supervision costs that IFRS 15 gives as examples of costs that relate directly to a contract.

A6. Paragraph 22 of IAS 16 discusses assets that an entity constructs both for sale in the normal course of business (ie inventories) and to hold for use within its business (ie property, plant and equipment). It links their measurement, stating that the cost of a self-constructed asset ‘is usually the same as the cost of constructing an asset for sale (see IAS 2).’

A7. Paragraph 47 of IFRS 17 contains requirements for onerous insurance contracts. Because onerous contracts within the scope of IFRS 17 are excluded from the scope of IAS 37, the two Standards do not interact so do not need to be consistent. However, ideally, their requirements would be similar, unless there are reasons for differences. The onerous contract test in IFRS 17 requires an entity to identify the ‘fulfilment cash flows allocated to the contract’. Using terminology similar to that in IFRS 15, IFRS 17 defines the fulfilment cash flows using the phrase ‘that relate directly to the fulfilment of the contract'. Paragraph B65 lists examples of fulfilment cash flows that are similar to those noted in paragraphs A3–A4 above.